Petition

81-1266

No.

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In the Supreme Court of the United States

October Term, 1981

MILTON W. IVIE, JR., GRAHAM H. LIGHTSEY, JR., and UNITED POWER DISTRIBUTORS, INC.,
Petitioners,

vs.

L. M. BROWN,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FORMER FIFTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

I. WHETHER THE FEDERAL SECURITIES LAWS ARE INTENDED TO GOVERN AN INTERNAL CORPORATE DISPUTE ARISING FROM THE TERMINATION OF ONE OF THREE PRINCIPALS IN A CLOSELY HELD CORPORATION AND THE IMPLEMENTATION OF A STOCK-PURCHASE AGREEMENT WHICH REQUIRED THE TERMINATED SHAREHOLDER TO OFFER TO SELL HIS SHARES BACK TO THE CORPORATION.

II. WHETHER THE ALLEGED OMISSION BY TWO PRINCIPALS IN A CLOSELY HELD CORPORATION TO INFORM A THIRD, PRIOR TO THE EXECUTION OF A STOCK-PURCHASE AGREEMENT, THAT THEY INTENDED TO REMOVE HIM AS AN EMPLOYEE OF THE CORPORATION, WOULD CONSTITUTE FRAUD IN CONNECTION WITH THE SALE OF A SECURITY WITHIN THE INTENDED MEANING OF THOSE TERMS AS USED IN SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 10b-5.

LISTING OF PARTIES

The Caption of the case in this Court contains the names of all parties. Petitioner United Power Distributors, Inc. has no parent, subsidiary or affiliate corporations.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FORMER FIFTH CIRCUIT

MILTON W. IVIE, JR., GRAHAM H. LIGHTSEY, JR., and UNITED POWER DISTRIBUTORS, INC., Petitioners herein, respectfully pray that a Writ of Certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Former Fifth Circuit rendered in these proceedings on November 12, 1981.

OPINIONS OF THE COURTS BELOW

1. On May 30, 1980, the United States District Court for the Northern District of Georgia granted the motion of Petitioners (then defendants) for judgment on the pleadings and dismissed the complaint for failure to state a claim within the purview of the federal securities laws and for lack of subject matter jurisdiction. The District Court's

opinion is reported at 409 F.Supp. 490 and is reproduced in Part (ii) of the Appendix.

2. On November 12, 1981, the United States Court of Appeals for the Former Fifth Circuit reversed the decision of the District Court. The Court of Appeals' opinion is reported at 661 F.2d 62 and is reproduced in Part (i) of the Appendix. Judgment was entered the same date in accordance with Rule 36, Federal Rules of Civil Procedure, and there is no separate document to be reproduced.

GROUNDS ON WHICH THE JURISDICTION OF THIS COURT IS INVOKED

The judgment of the Court of Appeals for the Former Fifth Circuit from which review is here sought was entered on November 12, 1981. It is believed that jurisdiction is conferred on this Court by 28 U.S.C. § 1254(1), in that Petitioners here seek review, by way of Writ of Certiorari, of a decision by a United States Court of Appeals in a civil case. This case is appropriate for the Court's review by way of Writ of Certiorari pursuant to Supreme Court Rules 17.1(a) and 17.1(c).

STATUTES AND REGULATIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national

> securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SEC Rule 10b-5, at 17 C.F.R. § 240.10b-5 (1977), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

Petitioner Ivie, Petitioner Lightsey and Respondent Brown are the only three stockholders in Petitioner United Power Distributors, Inc. ("UPD"), a closely held corporation organized pursuant to the laws of the State of Georgia. The three individuals have also served in various capacities as officers, directors and employees of UPD.

On September 17, 1976, UPD and the three stockholders entered into a "Buy-Sell Agreement", which obligated the

company to acquire the shares of any stockholder who died or became disabled and required that a stockholder who left the company offer to sell his shares at a price to be determined in accordance with the agreement. On March 2, 1979, the same parties entered into a superseding "Stock Purchase Agreement." Both agreements are of a type commonly used in Georgia to provide for the orderly transition of ownership and control of a closely held corporation.

The 1979 Stock Purchase Agreement contains the following provisions to be applied in the event of termination of one of the three principals:

> *RESTRICTION ON SHARES OF STOCK.* In the event that any of the Shareholders who are parties to this Agreement shall desire to sell, encumber or dispose of any or all of his shares of stock in the Corporation, at any time during his lifetime, or shall leave the employment of the Corporation, he shall offer in writing to sell or dispose of such shares to the Corporation at the then book value, as hereinafter defined, on the terms and conditions hereinafter set forth.[1]

The agreement went on to define "book value" in clear detail and, by so doing, to establish the agreed upon price at which the shares would be offered back to the corporation. The 1976 predecessor agreement contained virtually identical provisions governing the shares of a terminated principal and their valuation.

Shortly after the parties entered into the 1979 Stock Purchase Agreement, a disagreement among the principals arose, and Respondent Brown's employment with UPD was terminated. However, instead of honoring the provisions of that agreement by offering his stock back to

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1. The entire agreement is a part of the pleadings and will be made a part of the certified record.

the corporation, Brown initiated this action in the United States District Court for the Northern District of Georgia.[2] He claimed, in essence, that Ivie and Lightsey (and, therefore, UPD) had decided, prior to entering into the agreement, to terminate his employment; that they omitted to inform him of that fact; and that such omission constituted fraud in violation of federal securities laws and state laws.[3]

The District Court's jurisdiction over the federal securities claims was predicated upon Section 29 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa, and Section 22(a) of the Securities Act of 1933, 15 U.S.C. § 77v(a). No other "federal question" is suggested, and the pleadings stipulate to a lack of diversity of citizenship. Related state law counts in the complaint were alleged to have been brought pursuant to the doctrine of pendent jurisdiction.

Brown did not contend that UPD lacked the power to terminate him or that he was deceived into believing otherwise. He did not contend that he was misled in any respect concerning the nature of the agreement that he was entering into, including the agreement's requirement that he offer his shares back to the corporation in the event of his termination or the agreement's provision concerning the valuation of his shares in that event. His "claims" of securities fraud rest solely on the nondisclosures of an alleged decision to terminate his employment.

Petitioners filed answers and counterclaims and then moved the District Court to enter judgment on the plead-

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2. By consent order, Brown's stock was deposited in the Registry of the District Court, where it still remains.

3. As the pleadings demonstrate, Petitioners denied any such prior decision, denied any connection between the agreement and the termination, and maintained that the termination resulted solely from Brown's wrongful acts and omissions in connection with his duties as an employee of the company.

ings. Although, several related issues were also raised, the primary bases of the motion were: (1) that the allegations presented nothing more than an intra-corporate dispute of the type not intended by Congress to be governed by the federal securities laws; and (2) that, in any event, the alleged "fraud" was not "in connnection with the purchase or sale of any security," a prerequisite for the application of Rule 10b-5.

The District Court agreed, even after viewing the allegations contained in the pleadings in a light most favorable to Respondent. Accordingly, the trial court dismissed the federal counts of Respondent's complaint for failure to state a claim upon which relief could be granted under the federal securities laws. Since there was no remaining federal question, and no diversity of citizenship, the District Court also dismissed the remaining state law counts for lack of subject matter jurisdiction. 490 F.Supp. 409.

Respondent appealed to the United States Court of Appeals for the Former Fifth Circuit, and on November 12, 1981, that court reversed. 661 F.2d 62. Petitioners now seek this Court's review, by Writ of Certiorari, of the Court of Appeals' decision. For the reasons set forth below, we respectfully submit that the issues presented are clearly appropriate for this Court's review and that the decision of the Court of Appeals should be reversed.

ARGUMENT

"It seems anomalous to jig-saw every kind of corporate dispute into the federal courts through the securities acts as they are presently written." *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 480 n. 17, quoting from "Federalism and Corporate Law: Reflections Upon Delaware," 83 Yale L.J. 663, 700 (1974). And yet, the decision of the Court of Appeals would do just that here.

The issues for which this Court's review are now sought are clearly and precisely presented. Is a Stock Purchase Agreement, entered into by the three principals of a closely held corporation in order to provide for the orderly transition of ownership and control in the event of death, disability or termination of one of them, a transaction which Congress intended be regulated by the federal securities laws? Do the federal securities laws impose upon the principals of a closely held corporation a duty to disclose to one another their subjective intentions in entering into such an agreement, and, if so, does their failure to do so constitute "fraud" "in connection with" a "sale" of a "security", within the intended meaning of those terms of art? We respectfully submit that, especially in view of several recent decisions of this Court, the District Court was correct in answering these questions in the negative. We further submit that the Court of Appeals' decision to the contrary makes this Court's review particularly appropriate for the following reasons.

The Fifth Circuit has, by this decision, placed itself and the new Eleventh Circuit in direct and distinct conflict with the Courts of Appeals for the Third Circuit and the Eighth Circuit. *See, Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner and*

Smith, 562 F.2d 1040 (8th Cir. 1977). Conflicts between circuits are particularly appropriate reasons for this Court's review. Supreme Court Rule 17.1(a).

Moreover, this Court's exercise of its discretion to review the appellate court's decision is warranted by Supreme Court Rule 17.1(c). It appears that the decision is in conflict with principles enunciated in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), and other recent Supreme Court decisions. Even if minor factual differences result in the conclusion that *Santa Fe Industries* is not controlling here, then this case nevertheless presents an "important question of federal law which has not been, but should be, settled by this Court."

A. The Court of Appeals' Decision in This Case Creates a Conflict Among Four Circuits.

We submit that "[t]his case is another example of a trend we have observed with disturbing frequency, namely invocation of the salutory anti-fraud provisions of the federal securities laws in cases where those provisions are wholly inappropriate and wide of the Congressional mark." *Ryan v. J. Walter Thompson*, 453 F.2d 444, 445 (2d Cir. 1971), *cert. denied*, 405 U.S. 907 (1972). In following such a trend the Court of Appeals has created a substantial conflict among the circuits.

Ketchum v. Green, 557 F.2d 1022 (3d Cir.), *cert denied*, 434 U.S. 940 (1977), a decision followed by the District Court in this case, involved a "stock retirement agreement" similar in effect to the "Stock Purchase Agreement" at issue here. The plaintiffs in that case, who were officers and directors of the corporation and collectively controlled 45% of its shares, alleged that they were deceived by the defendants' misrepresentations and omissions regarding the other stockholders' intentions with respect to the termina-

tion of the plaintiffs. As a result, they alleged, their stock was acquired at less than one-fifth its fair value, and they sought relief under the federal securities laws, particularly Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

The Third Circuit Court of Appeals rejected the claim. In doing so, it first observed that

> "§ 10(b) was not designed to preempt, in effect, a large number of state corporation provisions. . . . [T]he Supreme Court intimated in *Bankers Life* [404 U.S. 6 (1971)] that the statute should not be construed so as to foster the federalization of corporate law. Not only is the legislative history of § 10(b) silent in this regard, but Congress repeatedly has rebuffed various proposals to preempt, in whole or in part, the field of corporate regulation." 557 F.2d at 1029.

To the contrary, the Fifth Circuit Court of Appeals in this case rejected the contention (and the District Court's holding) that such disputes are "beyond the purview of Rule 10b-5." 661 F.2d at 66.

In *Ketchum v. Green,* the Third Circuit also held that there was an inadequate nexus between the alleged deception and the termination of the plaintiffs and the concomitant acquisition of their shares to satisfy the "in connection with" requirement of Rule 10b-5. Again, in direct contrast, the Fifth Circuit Court of Appeals rejected the Third Circuit's approach (which had been followed by the District Court in the case at bar) and relied upon previous Fifth Circuit decisions that were clearly inapposite on their facts. 661 F.2d at 65.

In reaching a result contrary to the Third Circuit, the Fifth Circuit made an effort to distinguish the holding of *Ketchum v. Green* on the basis that the "fraud" alleged

here related to the defendants' motives in entering into the Stock Purchase Agreement while the "fraud" alleged there related to the termination itself. We respectfully submit that the attempted distinction is wholly artificial. Every such dispute will necessarily involve three steps: (1) the entering into of the agreement; (2) the triggering of the agreement; and (3) the acquisition of the stock pursuant to the agreement. For purposes of the federal securities laws, there is no justification for distinguishing between fraud in connection with step one, as was alleged here, and fraud in connection with step two, as was alleged in *Ketchum v. Green.* If anything, the latter is even more closely connected to the actual acquisition of the plaintiffs' stock.[4]

The inter-circuit conflict is not limited to the Fifth Circuit and the Third. In *St. Louis Union Trust Company v. Merrill Lynch, Pierce, Fenner & Smith,* 562 F.2d 1040 (8th Cir. 1977), the Eighth Circuit Court of Appeals reached a result identical to that reached by the Third Circut in *Ketchum v. Green.* Moreover, the new Eleventh Circuit Court of Appeals decided in its first decision to accept, as controlling precedent, the decisions of the Former Fifth Circuit. *Bonner v. City of Pritchard, Alabama,* 661 F.2d 1206 (11th Cir. 1981). As a result, there is now a clear conflict involving four circuits, with the Third and Eighth Circuits on one side of the issue and the Fifth and Eleventh

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4. Apparently, the Court of Appeals was also swayed by the argument that the Stock Purchase Agreement was a contract for the sale of a security and, therefore, a "sale of security" within definitions stated in the securities laws. 661 F.2d at 66. However, the court should have looked beyond mere labels to determine whether Congress intended that the transaction in question be regulated by the federal securities laws. Even if the Stock Purchase Agreement had been denominated a "contract for the sale of securities," that would not have made it one for purposes of those laws. *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975).

Circuits on the other. We respectfully urge this Court to exercise its discretion in accordance with Rule 17.1(a) and resolve this conflict.

B. The Decision in This Case Is in Conflict With Principles Enunciated by This Court in Recent Decisions and Presents an Important Federal Question Which Should Be Settled by This Court.

In several recent decisions, this Court has recognized that Congress did not intend that the federal securities laws serve as a panacea for all corporate ills or as a vehicle by which to bring all types of corporate disputes into the federal courts. In applying the federal securities laws to this intra-corporate dispute involving the control of a closely held corporation, a matter traditionally left to the regulation of state law, the Court of Appeals has ignored the principles set forth in this Court's decisions. Even to the extent that the appellate decision might be said not to be in direct conflict with decisions of this Court, because of some factual differences, it nevertheless presents an important federal question which needs to be resolved. Accordingly, this case is especially appropriate for this Court's discretionary review pursuant to Supreme Court Rule 17.1(c).

In 1971, this Court observed that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971). Since that time, this Court has consistently emphasized, in varying circumstances, that the federal securities laws are not unlimited in solving corporate problems, even those involving securities in some fashion, and that they were never intended to be. *See*,

e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975).

Most significantly, in *Santa Fe Industries Inc. v. Green,* 430 U.S. 462 (1977), this Court observed:

> No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this "term of art" if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as this, in which *the essence of the complaint is that shareholders were treated unfairly by a fiduciary.* . . . [A] private cause of action under the antifraud provisions of the Securities Exchange Act *should not be implied* where it is "unnecessary to ensure the fulfillment of Congress' purposes" in adopting the Act. 430 U.S. at 477 (emphasis supplied).

The Court went on to state its *reasoning* in the following terms:

> The result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. In addition to posing a "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5," this extension of federal securities laws would overlap with state corporate law. . . . "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."
>
> We thus adhere to the position that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." There may well be a need for uniform federal

> fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5 to "cover the corporate universe." 430 U.S. at 478-480 (citations omitted).

Several lower courts, including the District Court in this case, applied such reasoning in declining to expand, by "judicial extension", the scope of federal jurisdiction over corporate disputes such as this. *See St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 562 F.2d 1040 (8th Cir. 1977); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977). Here, however, the Fifth Circuit Court of Appeals has chosen to pursue another course without even a reference to this Court's reasoning.

Respondent Brown did not allege any deception concerning the value of his shares or that their value was in any way manipulated. He did not allege any deception with respect to the nature of the agreement he was entering into or its requirement that he offer his shares back to the corporation in the event of his termination. He did not allege any deception with respect to the power of the corporation to terminate him. His only complaint is that he was terminated and that he was not told in advance of entering into the agreement of an alleged intention to do so.

Simply stated, the essence of Respondent's complaint is that he was treated unfairly by the other shareholders, officers and directors of the corporation. However, this Court held in *Santa Fe Industries* that unfair treatment was not intended by Congress to be within the scope of § 10(b)'s proscriptions. 430 U.S. at 477. Moreover, to find an actionable misrepresentation or omission, one must first conclude that the Petitioners had some fiduciary duty

to disclose their subjective intentions to Respondent. Again, however, this Court expressly declined to read any such fiduciary duty into the federal securities laws. 430 U.S. at 479.[5]

For the foregoing reasons, we respectfully submit that the Court of Appeals' decision in this case conflicts with the reasoning, if not the precise holding, of *Santa Fe Industries* and other decisions of this Court. Moreover, the decision creates an issue of substantial importance, not only to closely held corporations and the attorneys who advise them, but to the federal judiciary as well.

The closely held corporation is a common business entity - there must be thousands of them organized pursuant to varying corporate laws of different states. Many of them utilize the stock purchase agreement (or buy-sell agreement or stock retirement plan), not as an investment vehicle, but as a means for providing for the orderly transition of corporate control and management in the event of death, disability or termination of one of the principals.

Unfortunately, termination is often the result of differences among the principals and is likely to create additional differences. If the result reached by the Court of Appeals in this case is permitted to stand, many such differences will undoubtedly make their way into the federal courtroom to be litigated as securities fraud claims. We respectfully submit that no such result was intended by Congress or is permitted by this Court's prior decisions. We urge the Court to avert such a trend before it begins.

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5. Ironically, the Fifth Circuit has reached the proper result in another case, albeit from a different direction. In *Alabama Farm Bureau Mutual Casualty Company v. American Fidelity Life Insurance Company*, 606 F.2d 602 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980), the court held that § 10(b) and Rule 10b-5 do not impose a duty to disclose subjective intentions and that, so long as objective facts are disclosed, there is no federal cause of action.

CONCLUSION

For the foregoing reasons, and in accordance with Rules 17.1(a) and 17.1(c), we respectfully urge the Court to grant this petition and to review the decision of the Court of Appeals by Writ of Certiorari.

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CERTIFICATE OF SERVICE

I hereby certify that I have made due and legal service of the foregoing Petition for Writ of Certiorari upon Respondent in accordance with Supreme Court Rule by causing three copies thereof to be deposited in the United States mail, with first-class postage prepaid, addressed to his counsel of record.

This 5th day of January, 1982.

C. DAVID VAUGHAN
Counsel of Record for Petitioners

APPENDIX, Part (i)

L. M. BROWN, Plaintiff-Appellant,

v.

Milton W. IVIE, Jr., et al.,
Defendants-Appellees.

No. 80-7702.

United States Court of Appeals,
Fifth Circuit.*

Unit B

Nov. 12, 1981.

Appeal from the United States District Court for the Northern District of Georgia.

Before FAY, FRANK M. JOHNSON, Jr., and THOMAS A. CLARK, Circuit Judges.

FRANK M. JOHNSON, Jr., Circuit Judge:

Plaintiff L. M. Brown filed suit alleging that the defendants Ivie and Lightsey violated the federal Securities Act antifraud provisions by inducing him to enter into an agreement to sell his stock.[1] The district court dismissed the case, holding that plaintiff had failed to state a cause of action under the federal securities laws, and plaintiff appeals. We reverse.

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*Former Fifth Circuit case, Section 9(1) of Public Law 96-452—October 14, 1980.

1. Plaintiff alleged violations of Sections 10(b), 20, 27 and 29 of the Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78j(b), 78t, 78aa and 78cc(b); Sections 12 and 15 of the Securities Act of 1933, 15 U.S.C.A. §§ 77l and 77o; Rule 10b-5, 17 C.F.R. § 240. 10b-5, as well as a number of pendent state claims.

Brown and two defendants were each an officer, a director and a one-third shareholder in a closely held corporation, United Power Distributors, Inc. Brown and Lightsey were also employed as salesmen for the corporation. In 1976 the three stockholders entered into a "buy-sell agreement" that required shareholders no longer employed with the corporation to sell their stock back to the corporation at book value. By setting the purchase price at book value, the 1976 agreement insured that a shareholder would receive less than fair market value for the stock.[2] The 1976 agreement also contained a provision requiring that a restrictive endorsement be placed on all stock certificates stating that any transfer of stock was subject to the terms of the 1976 agreement. Brown avers that the stock certificates were never properly indorsed, thereby rendering the 1976 agreement unenforceable.

In 1979 the defendants decided to oust Brown from the corporation and force him to sell his stock back to the corporation at less than fair value. Ivie and Lightsey recognized, however, that the 1976 agreement was unenforceable and could not be used to force Brown to sell his stock. As a result, the defendants drafted a new agreement that embodied terms substantially identical to those in the 1976 agreement.[3] The 1979 agreement required

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2. The 1976 agreement guaranteed that the book value price of the stock would be less than the fair market value by excluding from the calculations of book value allowances for good will and other similar intangibles, appreciation of inventory, and appreciation of machinery, fixtures and equipment.

3. The 1979 agreement contained some substantive differences from the 1976 agreement. The amount of insurance on each shareholder was increased and the provisions dealing with the disposition of stock at a shareholder's death were also altered. However, the particular terms relevant to this case—those giving the corporation the right to buy a shareholder's stock at book value in the event that the shareholder was no longer employed with the corporation—were substantially identical in both agreements.

shareholders leaving the corporation to sell their shares back to the corporation at book value and to surrender possession of the stock certificates to a trustee. Brown was presented with the 1979 agreement and informed that the new agreement was necessary to effectuate a change in insurance companies and to increase the amount of insurance held by the corporation on each shareholder. The defendants omitted to tell Brown that they intended to oust him from the corporation and would be using the 1979 agreement to obtain his stock at less than fair value. Brown signed the agreement and seven days later defendants terminated his employment. Shortly thereafter Brown was also removed as officer and director. The defendants insisted that Brown sell his stock back to the corporation in accordance with the terms of the 1979 agreement. Brown refused and brought suit alleging that the defendants violated Section 10(b) of the Securities Exchange Act of 1934[4] and Rule 10b-5[5] by fraudulently induc-

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4. Section 10(b) provides in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C.A. § 78j.

5. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(Continued on following page)

ing him to enter into the 1979 agreement. Ivie and Lightsey counterclaimed for specific performance of the agreement. The district court dismissed Brown's suite, concluding that the alleged fraud had not been made "in connection with" the sale of a security as required by Rule 10b-5 and, alternatively, that the facts alleged by Brown involved an internal corporate dispute of the type not properly cognizable as a federal securities violation. 490 F.Supp. 409 (N.D.Ga.1980). The court also dismissed the defendants' counterclaims for lack of pendent jurisdiction over the subject matter.

[1-3] A necessary element of a Rule 10b-5 offense is that the fraud or deceit be "in connection with" the sale of a security. *Superintendent of Insurance v. Banker's Life & Cas. Co.*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971). In *Alley v. Miramon*, 614 F.2d 1372 (5th Cir. 1980), the Court determined that "in connection with" is to be flexibly applied but requires that there be a nexus between the defendant's fraud and the securities "sale". However, the "plaintiff in a Rule 10b-5 case need not establish a direct or close relationship between the fraudulent transaction and the purchase or sale, but only that the transaction [involving the sale] 'touch' the transaction involving the defendant's fraud." *Id.* at 1378 n.11. *Accord, Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 (5th Cir.), *cert. denied*, 419 U.S. 873, 95 S.Ct. 134,

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Footnote continued—

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person *in connection with* the purchase or sale of any security (emphasis supplied).

17 C.F.R. § 240.10b-5.

42 L.Ed.2d 113 (1974); *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 467 (7th Cir. 1981). Whether fraudulent omissions or misrepresentations are too remote to be "in connection with" the sale of a security depends upon the individual facts of each case. *See McGrath v. Zenith Radio Corp., supra,* 651 F.2d at 467; *Goodman v. Epstein,* 582 F.2d 388, 411 (7th Cir. 1978), *cert. denied,* 440 U.S. 931, 99 S.Ct. 1289, 59 L.Ed.2d 499 (1979). Applying the "touch" test enunciated in *Alley,* we conclude that the alleged fraud by the defendants was made "in connection with" the sale of a security.

The district court determined that "[a]ny alleged misrepresentation by the [defendants] as to why they wanted [Brown] to sign the [1979] agreement, is too remote to be 'in connection with' a securities transaction," 490 F.Supp. at 411, and relied primarily upon *Ketchum v. Green,* 557 F.2d 1022 (3d Cir. 1977), *cert. denied,* 434 U.S. 940, 98 S.Ct. 431, 54 L.Ed.2d 300 (1978) to support the conclusion. *Ketchum* is, however, readily distinguishable from the present case. In *Ketchum* the plaintiffs alleged that they were ousted from the corporation as a result of defendants' misrepresentations and required by the terms of a "stock-retirement agreement" to sell their stock back to the corporation at less than fair value. The *Ketchum* court concluded that the fraud was too remote to be "in connection with" the sale of a security. The court stressed that the objective of defendants' alleged fraud was to expel plaintiffs from the corporation in order to gain control and that the resulting sale of securities was simply an "indirect" consequence of plaintiffs' expulsion. Significantly, the defendants in *Ketchum* did not as an integral part of their scheme induce the plaintiffs to enter into the stock-retirement agreement; the agreement had been executed over seven years prior to the

alleged fraud. Thus, a nexus between the fraud and the securities transaction was clearly absent. *See also St. Louis U. Trust Co. v. Merrill Lynch, etc.*, 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925, 98 S.Ct. 1490, 55 L.Ed.2d 519 (1978) (fraud too remote from securities transaction where stock was sold to corporation pursuant to a longstanding agreement and plaintiff had not been fraudulently induced to enter into the agreement).

The facts, as alleged, in the instant case demonstrate a more direct causal connection between the fraud and the sale of securities than was present in *Ketchum*. Unlike the situation in *Ketchum*, Ivie and Lightsey collectively controlled two-thirds of the corporate stock and had the power to terminate Brown's employment at any time. It is alleged, however, that Ivie and Lightsey did not have an enforceable agreement that required Brown to sell his stock back to the corporation upon termination of employment. As a result, the plaintiff contends that the defendants fraudulently induced him to sign the 1979 agreement, thereby guaranteeing that they would obtain his stock at book value. Thus, accepting the fraud as alleged, there is a direct connection between it and the execution of the 1979 agreement obligating Brown to sell his stock for less than fair value. Since a contract for the sale or disposition of stock constitutes a sale of a security for purposes of the federal securities laws, 15 U.S.C.A. §§ 77b(3) and 78c(a)(14),[6] the defendants fraud, as alleged, is "in connection with" the sale of a security.

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6. Section 2 of the 1933 Securities Act states that the "term 'sale' . . . shall include every contract of sale or disposition of a security or interest in a security," 15 U.S.C. § 77b(3). Section 3 of the Securities Exchange Act of 1934 states that the "term 'sale' . . . include[s] any contract to sell or otherwise dispose of [securities]." 15 U.S.C.A. § 78c(a)(14).

[4] Defendants nevertheless contend that the alleged fraud was not "in connection with" the sale of a security because even had the 1979 agreement been vitiated by fraud, Brown would have been required to sell his stock to the corporation under the terms of the 1976 agreement. Defendants' argument is predicated upon the validity of the 1976 agreement. However, for purposes of a motion to dismiss, we are constrained to accept as true the facts stated in Brown's complaint. *Dudley v. Southeastern Factor and Finance Corp.*, 446 F.2d 303 (5th Cir.), *cert. denied*, 404 U.S. 858, 92 S.Ct. 109, 30 L.Ed.2d 101 (1971). Since Brown has alleged, albeit in an obtuse manner, that the 1976 agreement is unenforceable, we accept the fact as true and accordingly must reject defendants' argument.[7] Defendants attempt to salvage their position by contending that the district court had the authority to find the 1976 agreement valid as a matter of law. Even were the validity of the 1976 agreement ascertainable as a matter of law, we note that the issue was not briefed below and that the district court made no specific finding concerning the agreement's enforceability.[8] Moreover, Brown has based his contention that the 1976 agreement is unenforceable on a number of grounds, including estoppel, unclean hands, fraud, illegality and the failure to place a restrictive endorsement on the stock certificates. It would seem un-

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7. Plaintiff's complaint obliquely states that the 1976 agreement "was never consummated." Although the averment is not exactly a paragon of clarity, we are mindful that complaints are to be liberally construed, *Hargrave v. McKinney*, 413 F.2d 320, 324 (5th Cir. 1969), and conclude that the averment sufficiently conveys the notion that the 1976 agreement is invalid and unenforceable.

8. The district court labeled Brown's contention that the 1976 agreement had not been consummated "a puzzling assertion." 490 F.Supp. at 410. However, the court never made any specific finding as to the validity of the agreement.

likely that all of these grounds can be adjudicated by reference to the face of the pleadings, without any fact finding on the part of the district court.

[5] The district court also found that the corporate struggle between Brown, a minority shareholder, and the two defendants, the majority shareholders, was beyond the purview of Rule 10b-5 under the rationale articulated by the Supreme Court in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). In *Santa Fe*, the Supreme Court concluded that Rule 10b-5 did not encompass claims by a minority shareholder concerning a breach of fiduciary duty by the majority shareholders where there were no allegations of misrepresentation or nondisclosure. The Fifth Circuit has interpreted *Santa Fe* as precluding application of Rule 10b-5 only if the breach of fiduciary duty does not involve misrepresentations or nondisclosures. *Croy v. Campbell*, 624 F.2d 709, 716 n.7 (5th Cir. 1980); *Alley v. Miramon, supra*, 614 F.2d 1380 n.15. This interpretation of *Santa Fe* has been adopted by other circuits. *Panter v. Marshall Field & Co.*, 646 F.2d 271, 288 (7th Cir. 1981); *Healey v. Catalyst Recovery of Pennsylvania*, 616 F.2d 641, 646-47 (3d Cir. 1980); *Nash v. Farmers New World Life Insurance Co.*, 570 F.2d 558, 562 (6th Cir.), *cert. denied*, 439 U.S. 822, 99 S.Ct. 89, 58 L.Ed.2d 114 (1978); *Goldberg v. Meridor*, 567 F.2d 209, 218-19 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069, 98 S.Ct. 1249, 55 L.Ed.2d 771 (1978). Brown has averred the requisite nondisclosures and misrepresentations necessary to overcome the hurdles presented by *Santa Fe*. The complaint contains affirmative allegations that the defendants fraudulently misrepresented that the purpose of the 1979 agreement was to alter the insurance provisions and provide increased compensation in the event of a shareholder's death or disability, and that the defen-

dants fraudulently omitted to inform Brown that they sought the agreement in order to obtain his stock at less than fair value. Because of the presence of these allegations of fraud, Brown's claim is not beyond the scope of Rule 10b-5.

Our decision intimates no position as to the merits of plaintiff's case. We simply hold that the district court erred in concluding that plaintiff failed to state a claim under the federal securities laws.

REVERSED.

APPENDIX, Part (ii)

(Filed June 2, 1980)

IN THE
UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT
OF GEORGIA
ATLANTA DIVISION

CIVIL ACTION NO. C79-2211

L. M. BROWN,
Plaintiff,

vs.

MILTON W. IVIE, JR., GRAHAM H. LIGHTSEY, JR.,
and UNITED POWER DISTRIBUTORS, INC.,
Defendants.

ORDER

The facts underlying this complaint involve the ouster of a minority shareholder from a close corporation, United Power Distributors, Inc. The ousted shareholder, Brown, has brought his complaint under the anti-fraud provisions of the federal securities acts. He avers jurisdiction under Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa) and Section 22(a) of the Securities Act of 1933 (15 U.S.C. §77v(a)). The complaint contains four counts which purport to assert violations of the federal securities laws by the defendants who are the remaining shareholders in the corporation. Further counts set out claims under Georgia securities laws and common law fraud and equity concepts. In answering, defendants have counterclaimed for damages and equitable relief. Before the court today is Defendants' Motion for Judgment on

the Pleadings, and Plaintiff's Motion to Dismiss Counts 3 Through 6 of Defendants' Counterclaim.

The court will consider first the motion for judgment on the pleadings. In the complaint, Brown has averred that he and defendants Ivie and Lightsey were sole shareholders of United Power Distributors, Inc., each owning one-third of the outstanding shares. At all relevant times, Ivie was a director and president; Lightsey was a director and treasurer, as well as a salesman employed by the corporation; and plaintiff Brown was a director and secretary and was employed as a salesman by the corporation until he was removed from those positions by the defendants in March and April of 1979.

Brown avers that in 1976, he, Ivie, and Lightsey signed a Buy-Sell Agreement providing for the repurchase of stock by the corporation at book value if a shareholder left the corporation or died. In a puzzling assertion, Brown states that "this agreement was never consummated." Continuing, Brown claims that prior to February 26, 1979, defendants Ivie and Lightsey chose to join forces to oust him as director, officer and employee of the company. In pursuit of that scheme, they secured his signature to a Stock Purchase Agreement, stating that the purpose of the agreement was to allow a change in insurance companies and a change in the amount of insurance purchased on the lives of the three shareholders. Brown avers that he was not told that Ivie and Lightsey had decided to remove him and that their purpose in securing his signature to the Stock Purchase Agreement was to acquire his shares for less than their fair value—namely, at book value. Brown avers that he signed the Stock Purchase Agreement in reliance on those material and false representations. As required by the Stock Purchase Agreement, Brown turned over physical possession of his shares to John H. Moore, a trustee, for a restrictive endorsement to be en-

tered upon the certificates. A week later, Ivie and Lightsey terminated Brown's employment and shortly thereafter removed him as secretary and director.

Brown brought this suit against Ivie and Lightsey, also naming the corporation as a defendant under Section 20(a) of the Exchange Act (15 U.S.C. §78t(a)), and Section 15 of the Securities Act (15 U.S.C. §770.)) Brown's basic claim is that the foregoing actions violated Section 10(b) of the Exchange Act, 15 U.S.C. §78j(b) and Rule 10b-5 promulgated thereunder. Section 10(b) reads in pertinent part as follows: "It shall be unlawful for any person . . . by the use of any means or instrumentality of interstate commerce . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . for the protection of investors."

After consideration, the court concludes that any misrepresentation or omission which might have occurred here was too remote from a securities transaction to have violated the federal acts.

A case closely in point is *Ketchum v. Green,* 557 F.2d 1022 (3rd Cir. 1977) cert.den. 434 U.S. 940. *Ketchum v. Green* also involved the ouster of two directors of a close corporation who owned between them roughly 45% of its shares. The defendants were other directors and officers of the corporation, of whom 5 held together approximately 48% of the outstanding stock. Plaintiffs alleged that there was a usual practice among the directors of following the suggestions of the nominating committee for the slate of candidates for the board and officerships. Relying on the usual practice, Ketchum and Bigler, who actually possessed the controlling block of stock as they had their own holdings together with proxies obtained

from others, joined the defendants and unanimously elected the incumbent directors assuming that the defendants would honor the usual practice with respect to officerships. Plaintiffs averred that the defendants concealed their real plans which involved agreement among themselves to dislodge the plaintiffs as officers. Immediately following the shareholders meeting, the board convened to elect officers, at which point the defendants made known for the first time their intention to expel the plaintiffs as officers. Defendants rejected the nominations of the plaintiffs, and elected their own nominees, thereby removing plaintiffs as officers. Following their ouster, the plaintiffs were required by the provisions of a stock retirement plan to sell their shares to the corporation. The lawsuit was brought at that point under Section 10(b) and Rule 10b-5 seeking to enjoin their ouster as officers and shareholders and to recover damages.

The Third Circuit, considering that complaint, found that it was subject to dismissal for failure to state a claim. The court found that any misrepresentation was not "in connection with" a sale or purchase of a security: "It thus is evident that the alleged misrepresentations on the part of the defendants were undertaken with the objective of inducing the expulsion of the plaintiffs as officers and employees—not to foster the surrender of their stock. While it may be that surrender of the shares will constitute a *consequence* of the defendants' overall scheme, we believe that such a consequence, at best, will be an indirect one. Accordingly, it would appear that the deceptive practices in which the defendants are alleged to have engaged and the ultimate sale of plaintiffs' stock are not tied sufficiently tightly so as to surmount the 'connection' requirement of §10(b) even as broadly formulated in *Bankers Life.*" 557 F.2d at 1028.

This court finds that *Ketchum v. Green* and similar cases, *e.g., St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040 (8th Cir. 1977), support the proposition that plaintiff's complaint does not aver a sufficiently close connection between a misrepresentation and any stock transaction. The element of causation is missing. Plaintiff does not allege that he was prevented from reading or understanding the Stock Purchase Agreement and the obligations it placed upon him, nor that any deception was present within that Agreement. Any alleged misrepresentation by the other directors as to why they wanted him to sign the Agreement, is too remote to be "in connection with" a securities transaction, and could not have been a cause of any loss by plaintiff.

Moreover, the court finds that under the rationale of *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the corporate struggle involved in the instant lawsuit was not intended to be covered by the securities laws. In *Santa Fe Industries*, the United States Supreme Court refused to extend Section 10(b) and Rule 10b-5 to cover an alleged breach of fiduciary duty by a majority of stockholders in connection with a Delaware corporate merger. There, the Court wrote that "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in Cort v. Ash, supra: 'Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.' [Citation omitted]. We thus adhere to the posi-

tion that 'Congress by §10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.' " 430 U.S. at 479.

It follows that Counts 1 through 4 of plaintiff's complaint fail to state a claim under the federal securities laws. The remaining counts of the complaint, dependent as they are upon concepts of pendant jurisdiction, must also be dismissed. Finally, the counterclaim of defendants, which is grounded in ancillary jurisdiction, will not be entertained because the court has no jurisdiction over the primary controversy. This result is not contested by defendants. Accordingly, though this issue has largely been mooted, plaintiff's motion to dismiss counts 3 through 6 of defendants' counterclaim will be granted.

It is hereby ORDERED that Defendants' Motion for Judgment on the Pleadings is GRANTED; Plaintiff's Motion to Dismiss Counts Three Through Six of Defendants' Counterclaim is GRANTED; and the complaint and the remaining counts of the counterclaim are DISMISSED for failure to state claims within federal jurisdiction.

So ORDERED this 30 day of May, 1980.

/s/ Robert H. Hall
Robert H. Hall
United States District Judge

Opposition

Office - Supreme Court, U.S.
FILED
FEB 8 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-1266

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

MILTON W. IVIE, JR., GRAHAM H. LIGHTSEY, JR., and UNITED POWER DISTRIBUTORS, INC.,

Petitioners,

vs.

L. M. BROWN,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FORMER FIFTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether inducing a shareholder to sign a stock purchase agreement that obligates him to sell his shares to the corporation at a depressed price upon the termination of his employment and to place a restrictive endorsement on his stock, while at the same time representing that the agreement is necessary for insurance purposes but concealing a present intent to fire him immediately thereafter and thereby trigger the repurchase provision, constitutes fraud "in connection with" the sale of a security in violation of section 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5;

2. Whether inducing a shareholder to enter into a stock purchase agreement obligating him to sell his shares back to the corporation at a depressed price upon the termination of his employment, and then firing him seven days later so as to trigger the repurchase provision of the agreement,

constitutes no more than a breach of fiduciary duty or an internal struggle for corporate control within the meaning of Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), so as to be beyond the scope of the federal securities laws.

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STATEMENT OF THE CASE

Course of Proceedings:

The plaintiff-respondent L.M. Brown filed this action asserting violation of sections 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5 promulgated by the Securities and Exchange Commission under section 10(b), 17 C.F.R. § 240.10b-5; and section 12 of the Securities Act of 1933, 15 U.S.C. § 771. Plaintiff also stated claims, by virtue of the district court's pendent jurisdiction, for violations of the Georgia Securities Act of 1973 and various fraud provisions of Georgia statutory law and the common law.

On February 7, 1980, the defendants filed a motion for judgment on the pleadings. The district court granted the defendants' motion on the ground that the fraud alleged by the plaintiff did not occur "in connection with" the sale of the plaintiff's stock, and that the subject of

plaintiff's complaint was merely a struggle for corporate control, a matter relegated to state law, beyond the reach of the federal securities laws.

On appeal, the United States Court of Appeals for the Former Fifth Circuit reversed the district court's order, holding that the fraud alleged in the complaint was sufficiently connected to the sale of a security to satisfy the requirements of section 10(b) and that the subject matter of the suit was within the purview of the federal securities laws.

Statement of Facts:

For purpose of ruling on the propriety of the grant of defendants' motion for judgment on the pleadings, as will be more fully discussed below, the allegations of plaintiff's complaint must be taken as true, and the defendants' contrary assertions must be taken as false unless they are admitted

by plaintiff. For that reason, and because no discovery has yet been conducted, the allegations of Mr. Brown's complaint constitute all the facts for purposes of this petition for writ of certiorari. Those facts are as follows:

Mr. Brown was one of three shareholders of a close corporation, United Power Distributors, Inc. He, along with the defendants Ivie and Lightsey, each owned one-third of the outstanding shares of the corporation. Each of the three men was a director of the company. Mr. Ivie served as President; Mr. Lightsey served as Treasurer and was also employed as a salesman by the company; and Mr. Brown held the position of Secretary and was also employed as a salesman.

Sometime prior to March 2, 1979, the defendants Ivie and Lightsey decided to use their combined power to oust Mr. Brown from the company. They were not content with

removing Mr. Brown as an officer, director, and employee of the company, but also wanted to force him to sell his stock to them at a price substantially below its fair value. They discovered that a buy-sell agreement signed by the parties in 1976 was ineffective to accomplish their purpose because it had never been consummated--none of the three shareholders had ever allowed an endorsement restricting transfer to be entered on his stock certificate, and this failure rendered the agreement unenforceable. To ensure that they could obtain Mr. Brown's stock after he was forced out of the company, Mr. Ivie and Mr. Lightsey decided to have all parties execute a new agreement.

Pursuant to their plan, on March 2, 1979, they presented Mr. Brown with a document entitled "Stock Purchase Agreement" and requested that he sign it. The new agreement was similar to the 1976 agreement

but contained additional provisions requiring Mr. Brown to transfer possession of his stock to a trustee, and allowing the trustee to place a restrictive endorsement on the stock certificate.

Mr. Brown was told that the purpose of the new agreement was merely to allow a change in life insurance companies and an increase in the amount of insurance purchased on the lives of the three shareholders. (Portions of the agreement provided for the purchase of "key man" insurance on the lives of the three shareholders, and also provided that in the event of death the policy proceeds would be used to purchase the deceased shareholder's stock.) Mr. Ivie and Mr. Lightsey did not tell Mr. Brown that they had decided to fire him and remove him as a director.

Mr. Brown signed the new agreement and, as required by its terms, delivered his stock certificate to the trustee under the

agreement, so that an endorsement restricting transfer could be entered on the certificate. The trustee placed the restrictive endorsement on Mr. Brown's stock certificate and then retained possession of it. The endorsement read: "The shares represented by this certificate are subject to and/or transferable only on compliance with an agreement dated March 2, 1979, among Milton W. Ivie, Jr., L. M. Brown, Graham H. Lightsey, Jr., United Power Distributors, Inc., and John H. Moore."

When Mr. Brown signed the new agreement he had every expectation of staying with the company as an officer, director, employee, and shareholder. Because the agreement applied to all three shareholders, Mr. Brown thought that he could benefit from the agreement as readily as the defendants.

Seven days after Mr. Brown signed the stock purchase agreement, Mr. Ivie and Mr. Lightsey fired him from his position with

the company, thereby triggering the repurchase provision of the agreement. Shortly thereafter, they removed him from his positions as an officer and director of the company.

After their ouster of Mr. Brown, the defendants insisted that he offer his stock to the company on the terms specified in the stock purchase agreement. Furthermore, in this action Mr. Ivie and Mr. Lightsey filed a counterclaim requesting specific performance of the agreement.[1]

SUMMARY OF ARGUMENT

The district court's order granting the defendants' motion for judgment on the pleadings was based upon two grounds: (a) that the fraud alleged did not occur "in connection with" the sale of Mr. Brown's

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1 Some of the relevant portions of the complaint, reciting the above-stated facts, are reproduced in the Appendix.

stock within the meaning of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and (b) that the claim asserted by plaintiff amounted to no more than an internal struggle for corporate control which was outside the realm of the federal securities laws.

The Fifth Circuit correctly held that the district court erred on both portions of its decision.

With regard to the first ground of the district court's ruling, the factual allegations of plaintiff's complaint--which must be taken as true in ruling upon the motion for judgment on the pleadings[2] --clearly establish that the entire purpose of the defendants' fraud was to induce plaintiff to enter into the very contract that now requires him to sell his stock to

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2 See 2A Moore's Federal Practice ¶ 12.15, at 2343.

the corporation at a depressed price. The defendants did not need to deceive plaintiff so that they could oust him from the company, because as controlling shareholders they already possessed the power to do so even without the fraud. Rather, they deceived him for the sole purpose of ensuring that they could obtain his stock for less than its fair value. The federal courts have consistently held that the "in connection with" standard is to be applied in a liberal, flexible manner, and that the fraud need only "touch" the sale in order to be connected with it. The connection between the fraud and the sale is directly and unequivocally pleaded. It more than touches the sale; it is the moving force which brought it about.

The district court also erred with regard to the second ground for its dismissal. The case of Santa Fe Industries, Inc. v. Green, which the district court

regarded as controlling, only precludes application of the federal securities laws to those intra-corporate disputes in which no fraud is alleged. Plaintiff in the present case has pleaded that the defendants made misrepresentations regarding the purpose of the stock purchase agreement and that they omitted to state the material facts that they intended to fire him, that they wished to acquire his stock for less than its fair value, and that the complete execution of the agreement would allow them to accomplish their goal. The Fifth Circuit correctly recognized that the complaint states a claim falling squarely within the reach of the federal securities laws.

ARGUMENT

The defendants assert that their petition for writ of certiorari should be granted for two reasons: (1) The Fifth Circuit's decision created a conflict among

the circuits; and (2) the decision conflicts with this Court's opinion in Santa Fe Industries Inc. v. Green, 430 U.S. 462 (1977).[3]

Both of these assertions are incorrect. The Fifth Circuit's decision is entirely consistent with, and follows logically from,

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3 In footnote 4 of the petition for writ of certiorari, the defendants apparently also contend that the stock purchase agreement was not a "contract for the sale of securities" within the meaning of sections 3(a)(10) and (14) of the Securities Exchange Act of 1934. This argument was not raised in either of the courts below and should not be considered here. However, it is well-settled that the stock purchase agreement constitutes a "sale" within the meaning of the federal securities laws. See Dudley v. Southeastern Factor and Finance Corp., 446 F.2d 303 (5th Cir.), cert. denied, 404 U.S. 858, 92 S. Ct. 109, 30 L. Ed. 2d 101 (1971); Ketchum v. Green, 557 F.2d 1022, 1030 n.25 (3d Cir.), cert. denied, 434 U.S. 940, 98 S. Ct. 431, 54 L. Ed. 2d 300 (1977). It is also established that a "forced seller" of securities may maintain a claim under the securities laws. See Falls v. Fickling, 621 F.2d 1362, 1365-66 (5th Cir. 1980); Alley v. Miramon, 614 F.2d 1372, 1384-87 (5th Cir. 1980).

existing case law, including Santa Fe Industries.

A. There is no conflict among the circuits

The defendants do not dispute the fact that the "in connection with" standard is to be construed in a liberal, flexible manner, and that the misrepresentation or omission of material fact need only "touch" the purchase or sale of a security to satisfy the requirement. See Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971); Alley v. Miramon, 614 F.2d 1372, 1378 n.11 (1980). There is certainly no conflict among the circuits on this point.

Rather, the purported conflict is between this case and Ketchum v. Green, 557 F.2d 1022 (3d Cir. 1977), cert. denied, 434 U.S. 940 (1978). An examination of Ketchum reveals that the Fifth Circuit's opinion is

entirely consistent with it and that no conflict exists.

In Ketchum, the two plaintiffs, whose stock holdings, together with proxies, gave them a controlling interest in the company, followed a practice of supporting the reelection of the other incumbent directors, who would then reelect plaintiffs as officers of the company. Plaintiffs alleged that, in reliance on this usual practice, they reelected the incumbent directors, but that these directors then carried out their concealed plan to elect new officers, thereby removing plaintiffs from their position of control. Plaintiffs brought suit under the federal securities laws in an attempt to enjoin the defendants from ousting them from control.

The Third Circuit noted that a stock retirement plan executed over seven years earlier required plaintiffs to sell their stock to the corporation after their ouster.

The court found, however, that the allegations of the complaint made it clear that "the alleged misrepresentations on the part of the defendants were undertaken with the objective of inducing the expulsion of the plaintiffs as officers and employees--not to foster the surrender of their stock." 557 F.2d at 1028. Thus, the Third Circuit held that the complaint was properly dismissed by the district court because the fraud did not occur in connection with the forced sale.

The court in Ketchum expressly based its decision on the fact that the fraud alleged by the plaintiffs was accomplished in order to remove plaintiffs as officers of the corporation; the ouster could not have occurred without the fraudulent concealment of defendants' plan. The fraud in Ketchum induced the plaintiffs to vote for the defendants as directors; it did not cause them to enter into a contract to sell their

stock. The forced sale of stock, on the other hand, was not brought about directly by the fraud. Rather, it was brought about by an existing, unquestionably enforceable stock retirement agreement executed several years earlier. No fraud had occurred in connection with the execution of this agreement. The fraud that did occur was accomplished so that plaintiffs could be removed from active control--not so that the stock would have to be surrendered.

In the present action the defendants made the misrepresentations and omissions for the purpose of inducing Mr. Brown to agree to sell the corporation his stock, and to sell at the price they wanted to pay. The fraud was not necessary to remove Mr. Brown as an officer and director of the company. Mr. Ivie and Mr. Lightsey together owned two-thirds of the outstanding shares of the corporation. As majority shareholders, they could use this power to

remove plaintiff from his positions as officer and director at any time they pleased, without the necessity of any deception or concealment of facts. But they could not have forced him to give up his stock at a depressed price without the fraud.

Thus, the fraud alleged in the complaint did not bring about the removal of Mr. Brown as an officer or director. The defendants had already made the decision to remove him, and their misrepresentations and nondisclosures did nothing to enhance their ability to do so. The fraud was accomplished in order to force the sale of stock, and was therefore directly connected to the sale.[4]

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4 The case of St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, 562 F.2d 1040 (8th Cir. 1977), also cited by the defendants, is quite similar to Ketchum. As the Fifth Circuit has observed, the basis for the St. Louis decision was that

B. This action is within the purview of the federal securities laws and does not conflict with Santa Fe Industries, Inc. v. Green

As previously outlined, this action concerns a stock purchase agreement signed by plaintiff in March 1979. That agreement requires any shareholder leaving the employment of United Power Distributors, Inc., to sell his stock back to the company at a defined price, which price is only a

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> there was nothing that plaintiff there could have done to prevent Merrill Lynch from purchasing the stock at the price established by a formula set long before. . . . [T]he insiders who were planning to go public could have announced to all the world that a public offering was imminent. They could then have proceeded to exercise the option to purchase the deceased partner's stock at the price determined by the option agreement. The plaintiffs would have received not a dollar more than they actually received.

Falls v. Fickling, 621 F.2d 1362, 1367 (5th Cir. 1980).

fraction of the true value of the stock. Plaintiff maintains that the defendants Ivie and Lightsey decided to fire Mr. Brown from his positions as an officer, director, and employee of the company, and they devised a scheme to acquire his stock at a depressed price. To carry out their scheme, they first induced plaintiff to sign the stock purchase agreement without telling him that they were going to remove him from the company; next they obtained possession of his stock and placed an endorsement restricting transfer on it. Then, seven days later, they fired Mr. Brown, thereby triggering the repurchase provisions of the agreement.

The defendants contend that this case presents a novel theory of federal securities law because it attempts to "jig-saw" a simple dispute over corporate control into a federal securities claim. Central to defendants' argument are two

assertions: (1) This case is nothing but a disguised claim for plaintiff's wrongful removal as a corporate officer, director, and employee; and (2) the Supreme Court's decision in Santa Fe Industries, Inc. v. Green holds that disputes between corporate insiders are beyond the reach of the federal securities laws. The defendants are wrong in both assertions.

First, this action is not a fight over control of United Power, it is not a claim that Mr. Brown was wrongfully removed from his positions in the corporation, and it is not a claim for corporate mismanagement. If this were such a case, plaintiff would have asked the lower court to enjoin his removal, order his reinstatement, award him back salary, order the defendants to account for misused funds, or other similar prayers for relief. In actuality, Mr. Brown's complaint asked for none of these remedies. Rather, Mr. Brown requested that the stock purchase

agreement be rescinded, or, in the alternative, that he be awarded damages representing the difference in value of his stock before and after the execution of the agreement.

In this litigation plaintiff has not disputed his removal as an officer or employee of the corporation. He only disputes the defendants' ability under the federal securities laws to induce him to sign a stock purchase agreement with the fraudulently concealed intention to fire him immediately thereafter, and thereby to force him to give up possession of his stock, destroy its free transferability, and sell it to the defendants at a fraction of its true value.

Defendants' second assertion is that Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1977), precludes application of the federal securities laws to this case. Their

argument is that Santa Fe's "reasoning" is that no disputes between corporate insiders may be addressed under the federal securities laws. Under defendants' interpretation, a party only has to inject some element of intracorporate struggle into a securities fraud scheme to insulate himself from any liability under the federal securities laws.

Of course, the Santa Fe decision cannot be construed to say anything of the kind. It merely holds that absent fraud a breach of a director's fiduciary duty will not create a claim under the federal securities laws. Numerous decisions make clear that the securities laws remain applicable where fraud has occurred. See Alley v. Miramon, 614 F.2d 1372, 1380 n.15 (5th Cir. 1980); Healey v. Catalyst Recovery of Pennsylvania, 616 F.2d 641 (3d Cir. 1980); Kidwell ex rel. Penfold v. Meikle, 597 F.2d 1273, 1290-91 (9th Cir. 1979); Goldberg v. Meridor, 567

F.2d 209, 217-21 (2d Cir. 1977), cert. denied, 434 U.S. 1069, 98 S. Ct. 1249, 55 L. Ed. 2d 771 (1978).

In the present action, the defendants misrepresented the purpose of the 1979 stock purchase agreement as being solely to allow a change of insurance companies and an increase in the amount of insurance purchased on the lives of the three shareholders. Defendants omitted to disclose the correlative material fact that Mr. Brown would never have an equal opportunity to benefit from the agreement. They omitted the material fact that they planned to remove him from the corporation immediately after he signed the agreement. They omitted to tell him that the new agreement was being used because they feared the 1976 buy-sell agreement was unenforceable and because they wanted to destroy the transferability of Mr. Brown's stock by removing his stock certificate from

his possession and having the restrictive endorsement typed on it.

These misrepresentations and omissions take the present action beyond the mere breach of fiduciary duty that was alleged in Santa Fe, and thus that decision does not preclude application of the federal securities laws.

CONCLUSION

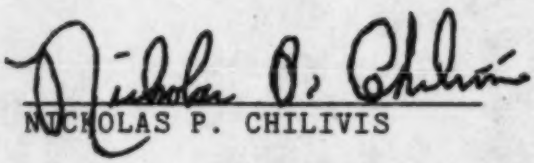
The controversy before this Court is based on nothing more than an attempt by the defendants to persuade the Court to ignore allegations clearly set forth in the complaint. They then contend that the complaint is insufficient because it lacks the very facts which they have excised.

We submit that the key to the "in connection with" standard is as follows: If the fraud influenced the plaintiff's investment decision, and if a purchase or sale of securities directly resulted from

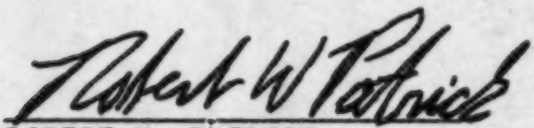
the decision, the fraud is "in connection with" the purchase or sale. In Ketchum v. Green, the fraud was not connected with the sale because the investment decision--i.e., the decision to execute the stock purchase agreement--was made several years before the fraud occurred. In the instant case, the fraud is directly connected with the sale because without it the plaintiff would not have made the investment decision he made; on the contrary, if he had known the truth, he would not have signed the contract for the sale of his stock.

The facts of this case fall squarely within the reach of the federal securities laws. Santa Fe Industries, Inc. v. Green correctly established that a breach of fiduciary duty, absent fraud, does not violate section 10(b) or Rule 10b-5. Fraud lies at the very heart of this case, however, and thus the Fifth Circuit is in step, rather than in conflict, with Santa Fe.

The petition for writ of certiorari raises no issue worthy of this Court's review. We respectfully submit that the petition should be denied.



NICHOLAS P. CHILIVIS



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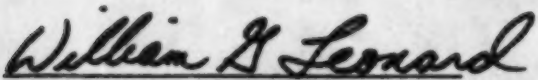

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served counsel of record for the petitioners in this action with three copies of the foregoing Respondent's Brief in Opposition to the Petition for Writ of Certiorari by depositing it in the United States mail in an envelope with adequate postage affixed, properly addressed as follows:

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This 5 day of February, 1982.

NICKOLAS P. CHILIVIS

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APPENDIX

Reproduced below are paragraphs 11 through 27 of the complaint:

11.

Mr. Brown, the Defendants Ivie and Lightsey, and a fourth shareholder formed United Power Distributors, Inc., on December 4, 1975. Each of the four contributed an equal amount of cash in exchange for 1,000 shares of stock in the new corporation. Soon thereafter, in early 1976, the fourth shareholder voluntarily left the employment of the company. From that time, and at all times relevant herein prior to March 1979, the Plaintiff and the Defendants Ivie and Lightsey each owned one-third of the outstanding shares of United Power Distributors, Inc.

12.

Because of the position of Defendants Ivie and Lightsey as equal shareholders and as fellow officers and directors of the corporation with Mr. Brown, they stood in a

fiduciary relationship and a confidential relation with Mr. Brown and were under a duty to disclose to him all facts material to his investment in the company.

13.

On December 17, 1976, Mr. Brown and the Defendants Ivie and Lightsey signed a Buy-Sell Agreement providing for the repurchase of stock if a shareholder left the corporation or if a shareholder died. The agreement included provisions requiring the purchase of a fixed amount of insurance on the life of each shareholder. This agreement was never consummated.

14.

On information and belief, some time prior to February 26, 1979, the Defendants Ivie and Lightsey decided to use their combined majority position as shareholders and directors to oust the Plaintiff as a director, officer, and employee of the company. In connection with this decision the Defendants discovered that the earlier

shareholder agreement had not been consummated and that the Plaintiff could transfer and sell his shares freely to whomever he chose and at their true market value.

15.

On or about February 26, 1979, the Defendant Ivie told Plaintiff that a meeting with Defendants Ivie and Lightsey would probably be held at the office of United Power Distributors, Inc., on March 2, 1979, and that it was necessary that Plaintiff attend. The date and time of the meeting was confirmed in a telephone call between Mr. Brown and Defendant Ivie on or about February 28.

16.

Mr. Brown attended the meeting on March 2, at which time the Defendants Ivie and Lightsey requested that he sign a Call and Waiver of Notice of a Special Meeting of the Board of Directors of United Power Distributors, Inc., and a Stock Purchase

Agreement, which had already been prepared. Mr. Brown was told that the purpose of the Agreement was to allow a change of insurance companies and a change in the amount of insurance purchased on the lives of the three shareholders. The Defendants did not tell Mr. Brown that Mr. Ivie and Mr. Lightsey had decided to remove Mr. Brown as an offfcer, director, and employee of the corporation, that they wanted to acquire Mr. Brown's shares for much less than their fair value, and that it was necessary for them to obtain his signature and delivery of shares pursuant to a new Stock Purchase Agreement in order to force him to offer his shares to the corporation at less than fair value.

17.

Through the statements of Defendants Ivie and Lightsey, both on and prior to March 2, 1979, Plaintiff was led to believe that the sole purpose of the March 2 agreement was to enhance the value of shares held by all remaining shareholders if one of

the shareholders should die or choose voluntarily to leave the employment of the corporation, and to provide for compensation of a shareholder in the event of disability or of his estate in the event of death. These representations were both material and false, the true purpose of the Defendants Ivie and Lightsey being to obtain possession of Mr. Brown's stock before they discharged him as an employee. Mr. Brown would not have signed the Stock Purchase Agreement if he had known its true purpose.

18.

In reliance on the representations of the Defendants Ivie and Lightsey and having no knowledge or reason to know of the facts which the Defendants Ivie and Lightsey omitted to disclose to him, Mr. Brown signed the Stock Purchase Agreement, which required each shareholder, including the Plaintiff, to transfer his shares of stock in United Power Distributors, Inc., to John H. Moore, trustee, and to allow the following

restrictive endorsement to be entered upon all stock certificates: "The shares represented by this certificate are subject to and/or transferable only on compliance with an agreement dated March 2, 1979, among Milton W. Ivie, Jr., L. M. Brown, Graham H. Lightsey, Jr., United Power Distributors, Inc., and John H. Moore." The Stock Purchase Agreement also provided that any shareholder who left the employment of the corporation was required to offer his shares to the corporation at the then book value, the definition of book value being determined by the Agreement.

19.

Also in reliance on the representations of the Defendants Ivie and Lightsey and having no knowledge or reason to know of the facts which they omitted to disclose to him, Mr. Brown allowed his shares to be delivered to John H. Moore, trustee, and allowed the restrictive endorsement to be entered thereon.

20.

One week later, on March 9, 1979, Defendants Ivie and Lightsey terminated Mr. Brown's employment. Soon thereafter, Defendants Ivie and Lightsey removed Mr. Brown as Secretary and as a Director of United Power Distributors, Inc.

21.

The misrepresentations and omissions of the Defendants Ivie and Lightsey constitute a manipulative or deceptive device used to mislead and defraud Mr. Brown.

22.

Mr. Brown exercised due diligence in connection with the March 2 Agreement and did not know and in the exercise of reasonable care could not have known of the falsity and misleading character of the Defendants' representations and nondisclosures.

23.

The foregoing misrepresentations, omissions, and manipulations were made or

engaged in by the Defendants Ivie and Lightsey knowingly and intentionally and for the purpose of defrauding Mr. Brown, or in reckless disregard of the fact that such fraud would result. At all times relevant herein, United Power Distributors, Inc., stood in a position of control over the conduct of Defendants Ivie and Lightsey as officers and directors within the meaning of Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), and Section 15 of the Securities Act, 15 U.S.C. § 77o, and had knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the Defendants Ivie and Lightsey is alleged to exist. Thus, the corporation is liable to the Plaintiff to the same extent as those individuals. The corporation is also liable to the same extent as the Defendants Ivie and Lightsey because in taking the actions herein complained of they acted as its agents and employees.

24.

The Stock Purchase Agreement of March 2, 1979, is a contract for sale of a security within the meaning of the Exchange Act.

25.

The contract for sale of the security was offered through and by use of the instrumentalities of interstate commerce and/or the United States mails.

26.

The foregoing misrepresentations, omissions, and manipulations were made in connection with the offer of, and the entry of the Plaintiff into, the contract for sale of his stock and constitute a violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder.

27.

As a proximate result of the foregoing misrepresentations, omissions, and manipulations, Plaintiff has been deprived

of the possession of his stock and damaged in the amount of $200,000.00.